BILL # HB 2489 **TITLE:** income tax rates; reduction

SPONSOR: Knaperek **STATUS:** As Amended by House WM

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FISCAL ANALYSIS

Description

This bill, as amended, would reduce individual and corporate income tax rates by 5% in calendar year (CY) 2006 and 10% in CY 2007 relative to current law.

Estimated Impact

This bill, as amended, would reduce individual income tax collections by $(155.5) million in FY 2007 and $(333.6) million in FY 2008. Corporate income tax collections would be reduced by $(58.6) million in FY 2007 and by $(82.7) million in FY 2008. Thus, the total General Fund revenue loss would be $(214.1) million in FY 2007 and $(416.3) in FY 2008.

These estimates are based on a static model and do not incorporate "dynamic" estimates. Dynamic forecasting goes beyond the static approach and attempts to predict changes in the economy brought about by changes in tax policy. The income tax reductions would lead directly to significant increases in households' disposable income and after-tax corporate profits. These increases would stimulate increased consumer and capital spending that would lead to higher levels of employment, construction, personal income, and additional revenue from sales, property, and insurance premium taxes. In addition, an even broader dynamic model would evaluate the impact of reductions in the growth in state spending resulting from the changes in tax policy. This spending impact, however, is difficult to evaluate until the specific reductions are known.

Dynamic estimates are based on complex econometric models. Based on national research, these models typically generate dynamic revenue feedbacks ranging from 2% to 20% of the static revenue impact within 5 years. In other words, up to 20% of the static revenue loss would be offset by revenues generated by greater economic activity. The specific feedback will depend on the type and magnitude of the tax reduction.

Due to time constraints, this analysis does not include a dynamic forecast for HB 2489. The impact, however, can be expected to fall within the typical dynamic feedback range.

The follow link posted on JLBC's website contains a document that provides a description of recent developments in dynamic revenue forecasting, including some results reported in other states: http://www.azleg.gov/jlbc/m-RevForecasting.pdf

Analysis

Individual Income Tax
Arizona uses a graduated tax system for the individual income tax, under which the tax rates vary from 2.87% to 5.04% of a taxpayer's taxable income. Under HB 2489, the rates for the state's 5 tax brackets would change as follows:

Single/Married Filing Separate Income Bracket	Married Filing Joint/Head of Household Income Bracket	Current Tax Rate	CY 2006	CY 2007
$0 - $10,000	$0 - $20,000	2.87%	2.73%	2.58%
$10,001 - $25,000	$20,001 - $50,000	3.20%	3.04%	2.88%
$25,001 - $50,000	$50,001 - $100,000	3.74%	3.55%	3.37%
$50,001 - $150,000	$100,001 - $300,000	4.72%	4.48%	4.25%
$150,001 and over	$300,001 and over	5.04%	4.79%	4.54%

According to the Department of Revenue (DOR), an across-the-board rate reduction of 5% in CY 2006 and 10% in CY 2007 would decrease individual income tax collections by an estimated $(155.5) million in FY 2007 and $(311.0) million in FY 2008.

DOR's estimated revenue loss of $(155.5) million in FY 2007 and $(311.0) million in FY 2008 was calculated based on the expected taxable income for the current calendar year (2006). While this is a reasonable approach for FY 2007, it will understate the revenue loss in FY 2008 since that figure was derived by applying the proposed 2007 tax rates to the 2006 baseline taxable income. In other words, DOR's FY 2008 estimate assumes no growth of taxable income in 2007.

Thus, to obtain a more realistic estimate of the FY 2008 revenue loss under the bill, the 2006 tax base was grown by about 7.3% to reflect the projected 2007 taxable income. This growth rate reflects the January JLBC Baseline estimate. Applying the proposed 2007 tax rates to the projected 2007 tax base results in a FY 2008 revenue loss of $(333.6) million relative to current law.

<u>Corporate Income Tax</u>
Under current law, the Arizona corporate income tax rate is 6.968% of a corporation's net Arizona taxable income or $50, whichever is greater. HB 2489, as amended, would reduce the corporate tax rate to 6.62% in CY 2006 and 6.27% in CY 2007.

Based on the JLBC FY 2007 Baseline forecast, a rate reduction of 5% in CY 2006 and 10% in CY 2007 would reduce corporate income tax liabilities by $(40.6) million and $(88.2) million, respectively. However, it is not known precisely when the impact of the rate reductions would affect actual tax collections. The revenue impact would occur over time as corporations make their quarterly estimated tax payments.

It is likely that the full impact of the rate reductions would be realized over 3 fiscal years due to variability in corporate income tax filing deadlines. For purposes of this analysis, 25% of the revenue impact would occur in year 1, 65% in year 2, and 10% in year 3. It should be noted, however, that since the first rate reduction is retroactive to January 1, 2006, the associated 25% revenue impact will not occur until FY 2007. Under this approach, the estimated static impact would be approximately $(58.6) million in FY 2007 and $(82.7) million in FY 2008.

Local Government Impact

Each year incorporated cities and towns receive 15% of individual and corporate income tax collections from 2 years prior. This bill would reduce local government distributions by $(32.1) million in FY 2009 and by $(62.4) million in FY 2010.

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